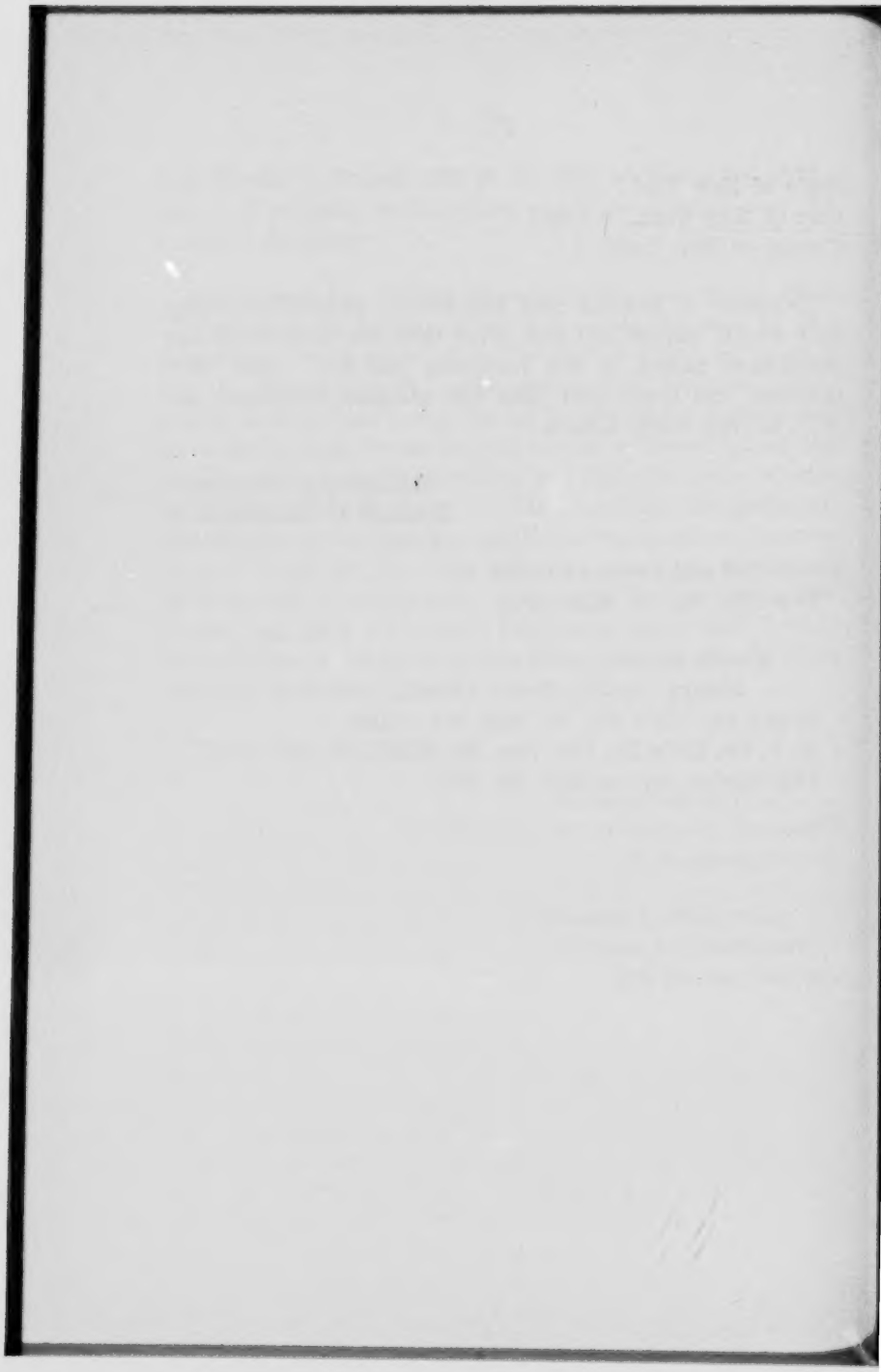

Supreme Court of the United States

OCTOBER TERM 1940.

SARGENT & COMPANY, a corporation, BAXTER, KELLY & FAUST, INC., a corporation, M. B. FITZGIBBON, doing business under the firm name and style of M. B. FITZGIBBON CO., and ANNA LOUISE LINAHAN,
Petitioners,

against

AGATHA L. MOORE, BASIL MOORE, MARGARET WIKSTROM, VINCENT JOYCE and M. HAROLD HIGGINS, and J. P. LINAHAN, INC., debtor in proceedings to reorganize a corporation under the National Bankruptcy Act,
Respondents.

BRIEF IN SUPPORT OF PETITION

POINT I

The Circuit Court of Appeals for the Second Circuit erroneously interpreted and applied the provisions of Chapter X of the Bankruptcy Act, and its decision is in direct conflict with the decisions of the Seventh and Third Circuits, and of this Court.

It has been pointed out in the foregoing petition that all parties admit the inability of the debtor to meet its debts and the need of reorganization under the Chandler Act. The District Court after trial has determined that adequate relief cannot be obtained in Chapter XI and that Chapter X

is the proper vehicle for reorganization. Far from disturbing these findings, the Circuit Court appears to recognize their validity when it suggests in its opinion that its decision unavoidably turns "upon a question of form rather than substance" (Tr. 724).

What, then, is the question of form upon which the decision of the Circuit Court turns and by reason of which it feels constrained to vitiate a reorganization which is in its final stages after more than a year of effort? It concerns the effect to be given to the answer and consent of the debtor.

Under the provisions of Chapter X, a creditors' petition is required to contain, in addition to the necessary allegations of a debtor's petition (Sec. 130), any one of the five statements set forth in Sec. 131. The petition filed herein contained the fifth of these, namely: "that the corporation has committed an act of bankruptcy within four months before the filing of the petition" (Tr. 8).

Upon the trial of the issues, the petitioning-creditors offered no proof of an act of bankruptcy. The creditors contended that the legal effect of the debtor's answer was the same as if the debtor had filed a voluntary petition in the first instance, in which event no allegation or proof of an act of bankruptcy would have been required (Sec. 130), and that, therefore, the question of an act of bankruptcy was no longer material.

The Circuit Court in construing the effect of the debtor's answer recognizes that the petition and answer and consent taken together complied in all respects with the requirements of Section 130 of the Act, for its says in its opinion:

> "It is indeed true, if we take the petition and answer together, that enough can be spelled out to satisfy the requirements of Sec. 130. The answer itself declares that the debtor is "unable to pay its debts as they mature", and not only consents to the approval of the petition, but prays that it should be approved; the other necessary facts it admits by not denying them.

Rule 8(d). Thus the debtor has expressly or impliedly made all the declarations that it need have made if it had filed a petition" (Tr. 720).

Nevertheless the Circuit Court held that the answer of the debtor did not have the effect of converting the proceeding into a voluntary one. In so deciding, it recognizes that it is going contrary to the decisions of two other Circuits, for it says:

> "Two circuits decided—one of them twice—that an answer in an involuntary proceeding which alleged all the facts necessary to a voluntary petition could be treated as a voluntary petition. *In Re Palisades-on-the-Desplaines,* 89 Fed. (2) 214 (C. C. A. 7); *In Re Park Beach Hotel Bldg.,* 96 Fed. (2) 886 (C. C. A. 7); *Snyder* v. *Fenner,* 101 Fed. (2) 736 (C. C. A. 3)" (Tr. 720).

In each of these decisions it was held that the debtor's answer consenting to an involuntary petition made unnecessary any proof of an act of bankruptcy. The opinion of the Seventh Circuit in *In re Palisades-on-the-Desplaines,* 89 Fed. (2d) 214-216, is so appropriate to the issues here involved that we quote from it at some length:

> "Appellant is the only objector to the decree of confirmation. He first contends that the court was without jurisdiction to consider the involuntary petition because of the absence of the allegation that the debtor had committed an act of bankruptcy within four months prior to its filing.
>
> We think there is no merit in this contention. Of course, the creditors' petition, standing alone, was defective, and for the reason urged by appellant it was not sufficient to give the court jurisdiction of the subject matter. However, before the court approved it, the debtor had filed its answer admitting the jurisdiction of the subject matter and the several allegations of the petition, and specifically averring its inability to meet its debts as they matured. Thereupon, the court entered its order of approval in which it used

the following language: 'Upon due consideration of the petition * * * and the answer of the debtor * * * stating that said debtor is unable to meet its debts as they mature and that it desires to effect a plan of reorganization in accordance with section 77B * * * and the court being satisfied that said petition complies with the said section and that it sets out facts showing need for relief, and that it has been filed in good faith, it is ordered. * * * "

(1) The facts here recited, in effect, made the proceeding a voluntary one and gave the court jurisdiction of the subject matter and the parties.

Subsection (a) of section 77B (11 U. S. C. A. Sec. 207(a) provides: '* * * If such answer shall admit (a) the jurisdiction of the court, and (b) the material allegations of the petition, the court shall enter an order approving the petition as properly filed under this section if satisfied that it complies with this section and has been filed in good faith.' The answer not only admitted jurisdiction, but it specifically admitted the facts which concededly gave the court jurisdiction of a voluntary petition. The words 'this section', just quoted, refer to section 77B, which sets forth the requirements of both a voluntary petition of the debtor and an involuntary petition of creditors.

(2) Construing all pertinent parts of the section together, we interpret the requirements of the involuntary petition, such as we have here, to mean that it shall contain the allegation of an act of bankruptcy within four months prior to its filing, or an admission by answer of the debtor that it is unable to meet its maturing debts. In such event, under that part of the section which we have quoted, it was obviously the duty of the court to approve the petition as properly filed under this section. This it did, and there was no error in so doing. Reason, we think, supports this conclusion. The debtor's verified answer avers facts sufficient to authorize the approval of a voluntary petition, and the court was warranted in so treating it. Whether it considered it as such, or regarded the creditors' petition, aided by the answer, as sufficient, is imma-

terial. Both are permissible under the statute, as we construe it, and either would carry out its plain intention. It is urged, however, that the court did not specifically approve the answer. That part of the section which we have quoted does not require that the court specifically approve the answer, but that it did consider its allegations, and approve, and rely upon them is quite manifest from the recitals of the decree.

(3) Certain authorities upon which appellant relies have been cited to the effect that jurisdiction can not be conferred by mere admission. As a general rule, that is true but that rule applies to cases where jurisdiction is inherently lacking. Here, however, the District Court was the only one which could have jurisdiction of the subject matter, and only upon conditions which depended entirely upon allegations of fact. The only one lacking was furnished by the debtor's admission, which it had a right to make, and under such circumstances we think jurisdiction was thereby conferred."

A similar conclusion was reached by the Seventh Circuit in *Park Beach Hotel Bldg. Corporation,* 96 Fed. (2d) 886 (cert. denied: 59 Sup. Ct. 105, 305 U. S. 638 mem.), (Supra), wherein an involuntary petition for reorganization was attacked by a creditor because it omitted to allege an act of bankruptcy. The Court said (page 891):

"Furthermore, the answer of the debtor, consenting to the jurisdiction and agreeing that there should be a reorganization, removed any possible error, for a corporation may become a voluntary petitioner for relief either by an answer to pending involuntary proceedings or by original petition. Section 77B of the Bankruptcy Act."

The Third Circuit, in *Snyder* v. *Fenner,* 101 Fed. (2d) 736 (Supra), agreed with the Seventh Circuit. It said, (page 738):

"Furthermore the debtor filed an answer admitting the allegations of the petition and joining in its prayers.

> This the debtor had a right to do even though a receiver was in possession of its property. *In re C. Moench & Sons Co.*, 2 Cir., 130 F. 685; *Struthers Furnace Co.* v. *Grant*, 6 Cir., 30 F. 2d 576. The effect of its answer was to convert the proceeding into a voluntary one and thus to remove from the case the questions as to the petitioning creditors' status and as to the debtor's solvency. *In re Palisades-on-the-Desplaines*, 7 Cir., 89 F. 2d 214; *In re Park Beach Hotel Bldg. Corp.*, 7 Cir., 96 F. 2d 886."

In rephrasing the provisions of Section 77-B, it was not intended to alter or change the rule stated above. This is evident from the statement which appears in the "Analysis of the House of Representatives' Bill of 12889" (The Chandler Act), 74th Congress, 2d Session, used by the Committee on the Judiciary. Commenting on Section 142 of Chapter X (pp. 64-65) of Analysis, the following statement is found:

> "The essentials of this provision are derived from 77B a. We have made some changes in language and have re-ordered and expanded the provisions for the sake of inclusiveness, clarity, and directness of statement." * * *
>
> "We have also discarded the provision which declares that, upon the approval of a creditors' petition, the proceedings shall continue as if the corporation had itself filed the petition. This would necessarily follow, and need not be spelled out."

See also, Jacob I. Weinstein's "The Bankruptcy Law of 1938, where at page 209 Mr. Weinstein, a member of the Drafting Committee, says in discussing Section 142:

> "It may here be noted that the clause of subdivision a of sec. 77B which provided that, upon the approval of the creditors' petition, the proceedings should continue as if the debtor had filed the petition, has been deleted. Under the revised structure of the Chandler Act, that express statement became unnecessary."

As in the cases above cited, the District Court in the instant proceeding likewise assumed jurisdiction upon the written consent and request of the debtor, and specifically based its approval order thereon, as well as on the creditors' petition (Tr. 37-43). Indeed the order recites that it is made on motion of the debtor's attorney (Tr. 38).

It has been stated that the additional allegations in a creditors petition required by Section 131 were enacted solely for the protection of a debtor from "aggressive and ill-timed actions by its creditors". Finletter, The Law of Bankruptcy Reorganization, page 38. The Second Circuit also holds this to be true, for it has said:

> "The first four of these five alternate allegations are in substance that the debtor's estate is already in process of some kind of administration; they are necessary only as a protection to the debtor, since they show that its business has already succumbed to legal custody. The fifth—an act of bankruptcy—is even more clearly for its protection" (Tr. 722).

Where, as in the instant case, a debtor joins with its creditors and seeks needed relief under Chapter X, the debtor obviously can waive those provisions which were included in Section 131 for its protection, since proof of the existence of any one of the five statements contained in that section is not necessary to confer jurisdiction on the Court.

The jurisdiction of the District Court did not depend upon the commission of an act of bankruptcy by the debtor. The Court had inherent jurisdiction of the subject matter and of the debtor, and all "other requisities to the jurisdiction" existed.

In Re Reisenberg, 208 U. S. 90, 28 Sup. Ct. 219.

The Second Circuit in discussing creditors' petitions in bankruptcy proceedings has heretofore held that the allegation and proof of an act of bankruptcy may be waived.

In Re S. W. Strauss & Co., 67 Fed. (2d) 605, 609; *Bradley* v. *Huntington*, 277 Fed. 948.

The Seventh Circuit has also so held *In Re Middlewest Utilities*, 70 Fed. (2nd) 825, 826.

The Circuit Court recognized (Tr. 720) that with the debtor's answer consenting to and invoking the jurisdiction of the court, all jurisdictional requirements of the Act were satisfied, but it nevertheless felt constrained to hold that the debtor's answer and consent could not convert the involuntary proceeding into a voluntary one. In reaching this conclusion, the Circuit Court treated the answer and consent as "serving as a petition for reorganization" (Tr. 721). Neither the Seventh nor the Third Circuit suggested that such an answer constituted a new and independent petition for reorganization, nor was it so contended before the court below by any party. On the contrary, it has always been contended by petitioners, that the creditors' petition and the debtor's consent constituted but one petition upon the basis of which the court assumed jurisdiction.

The Circuit Court argued that such an answer, when treated as a voluntary petition, violated Sec. 126 of the Act, which provides that a Chapter X petition may be filed only "if no other petition by or against such corporation is pending under this chapter". Neither the history nor the intent of Sec. 126 warranted the application of that Section to a case where the debtor consents to a creditors' petition. The purpose of that Section was to avoid conflict between original petitions which were either concurrent or inconsistent, or original petitions which would create questions of priority between petitions, or original petitions filed in conflicting jurisdictions. (Finletter, The Law of Bankruptcy Reorganization, pp. 92 to 98).

An answer which consents to a Chapter X proceeding in effect merely adopts or sponsors the creditors' petition

and, therefore, does not come within the prohibition contained in Sec. 126. Such an answer does not give rise to two separate petitions. It is but one petition, one proceeding, one court. It is the equivalent of a decree *pro confesso,* which has long been recognized as part of equity jurisprudence and practice.

In the *Matter of Reisenberg,* 208 U. S. 90, 28 Sup. Ct. 219 (*supra*), this Court stated:

> "Jurisdiction does not depend upon the fact that the defendant denies the existence of the claim made, or its amount or validity. If it were otherwise, then the circuit court would have no jurisdiction if the defendant simply admitted his liability and the amount thereof as claimed, although not paying or satisfying the debt. This would involve the contention that the Federal Court might be without jurisdiction in many cases where, upon bill filed, it was taken pro confesso, or whenever a judgment was entered by default. These are propositions which, it seems to us, need only to be stated to be condemned. The cases are numerous in which judgments have been entered by consent or default where the other requisites to the jurisdiction of the Federal Court existed. Hefner v. Northwestern Mut. L. Ins. Co., 123 U. S. 747-756, 31 L. ed. 309-313, 8 Sup. Ct. Rep. 337; Pacific R. Co. v. Ketchum, 101 U. S. 289, 296, 25 L. ed. 982-935."

This Court in discussing the applications of equitable principles in interpreting the provisions of the Act, stated in *Securities and Exch. Commission* v. *United States Realty & Improvement Co.,* 60 Sup. Ct. 1044, 310 U. S. 434, as follows (p. 1053 Sup. Ct., p. 455 U. S.):

> "A bankruptcy court is a court of equity, sec. 2, 11 U. S. C. Sec. 11, 11 U. S. C. A. sec. 11, and is guided by equitable doctrines and principles except in so far as they are inconsistent with the Act. Bardes v. Hawarden Bank, 178 U. S. 524, 534, 535, 20 S. Ct. 1000, 1004, 44 L. Ed. 1175; Continental Illinois Nat. Bank & T. Co. v. Chicago R. I. & Pacific Ry., 294

U. S. 648, 675, 55 S. Ct. 595, 605, 79 L. Ed. 1110; Wayne United Gas Co. v. Owens-Illinois Glass Co., 300 U. S. 131, 57 S. Ct. 382, 81 L. Ed. 557; Pepper v. Litton, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281."

(p. 1054 Sup. Ct., p. 457 U. S.):

"While a bankruptcy court cannot, because of its own notions of equitable principles, refuse to award the relief which Congress has accorded the bankrupt, the real question is, what is the relief which Congress has accorded the bankrupt and is it more likely to be secured in a Chapter X or Chapter XI proceeding? In answering it we cannot assume that Congress has disregarded well settled principles of equity, the more so when Congress itself has provided that the relief to be given shall be 'fair and equitable and feasible'. Good sense and legal tradition alike enjoin that an enactment of Congress dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part."

The construction we suggest is in harmony and consonant with all other provisions of the Act and the decisions above cited.

Section 142 provides as follows:

"If an answer is not filed by a debtor to a petition against it, or if the answer filed does not controvert any material allegation of the petition, the judge shall enter an order approving the petition if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied."

Since the District Court may approve a petition if the debtor defaults or its answer does not controvert any material allegations of the petition, how can it be said that it has not the power to accept an answer and consent, *pro confesso?* Such an answer is none the less one that does not "controvert any material allegations of the petition".

With such an answer we do not have a new and original proceeding. We have but one proceeding which is the equivalent of a voluntary one.

Palisades-on-the-Desplaines; 89 Fed. (2d) 214 (*Supra*);
Park Beach Hotel Building Corp., 96 Fed. (2d) 886 (*Supra*);
Snyder v. *Fenner,* 101 Fed. (2d) 736 (*Supra*).

Again the Circuit Court sacrifices substance for form when it construes Sec. 137 and concludes that a debtor by its consent cannot thereby prevent a creditor or stockholder from making issuable the commission of an act of bankruptcy.

The Court first advances the following cogent reasoning in support of the position that a creditor and stockholder should not have that right. It said (Tr. 722, 723):

> "The fifth—an act of bankruptcy—is even more clearly for its protection. It is impossible to see how a creditor or an 'indenture trustee' can have any interest in denying any one of them, assuming that the debtor's affairs are ripe for reorganization; and if Sec. 137 must be construed to give them that privilege, it was apparently an oversight. We do not forget that before 1938 a creditor, intervening in a liquidation proceeding, did have the privilege of contesting the act of bankruptcy; if he had a lien subject to challenge, this gave him the power to scotch the attack in limine. But Sec. 18 (b) has now been amended so that he no longer has that privilege, being relegated to his defense if the trustee attacks his lien. It will certainly be a curious anomaly if a creditor retains that privilege in reorganization which he has just lost in liquidation. As to shareholders, the privilege of denying the allegation required by Sec. 137 is of use only in cases where they could dispute a voluntary petition as well; that is, in those where the debtor's management was acting in fraud of their rights.

> For these reasons it seems to us at least doubtful that when, as here, the debtor chooses to pray for the approval of an involuntary petition, either creditor, 'indenture trustee' or stockholder can press to decision the added allegation required by Sec. 131; that is, can vicariously assume the debtor's defense as to something against which it does not want protection and in which as such the creditor can have no interest."

Despite these forceful arguments, the Circuit Court nevertheless concludes that "if Sec. 137 is read with strict literalness" a creditor or stockholder must retain the right to put in issue the commission of an action of bankruptcy, at the same time recognizing that this conclusion is a "curious anomaly".

This Court, in *Securities Exchange Commission* v. *United States Realty and Improvement Co.* (*Supra*), held "that an enactment of Congress dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part". The Circuit Court has not done this and has disregarded the intent of Congress. If Sections 130, 131 and 137 are read together, instead of distributively, it becomes apparent: that Sec. 131 was enacted solely for the benefit of the debtor; that if the debtor itself seeks reorganization and joins with the creditors to obtain the approval of the petition, it should not be deprived of the rights which are expressly given it by Sec. 130; and that Sec. 137 was intended to give a creditor or stockholder the right to raise only those issues which would be available to them if the petition had been a voluntary one.

This construction still reserves to creditors and stockholders all issues other than those involved in the allegations required by Sec. 131 and also preserves the functional efficiency of the Act.

POINT II

The Circuit Court of Appeals for the Second Circuit by its decision seriously impedes the proper administration of Chapter X.

Section 77B and Chapter X were enacted for the primary purpose of simplifying and expediting the complicated and cumbersome reorganization procedure which formerly existed in equity proceedings. The Circuit Court, in disregard of the fundamental purpose of Section 77B and Chapter X, has read into the Act conditions which frustrate its purpose and which operate to prevent a speedy reorganization. It has abolished a decree pro confesso to the jurisdiction of the court in Chapter X proceedings initiated by creditors, and has created impediments which did not even exist in equity proceedings.

The Circuit Court has hamstrung any debtor in need of reorganization under Chapter X where the creditors have taken the initiative by filing a petition for reorganization and where none of the statements required by Sec. 131 factually exist or may be issuable. If its decision is to be adhered to, a debtor in need of reorganization under such circumstances has a choice of only one of three courses: (a) to file an answer admitting all of the allegations of the creditors' petition, including an act of bankruptcy; (b) to default in pleading; or (c) to contest the creditors' petition.

As a practical matter no officer or director of the corporation will admit that an act of bankruptcy has been committed, whether it be by default in pleading or by direct admission, if in fact no such act had been committed, or if the act was issuable. In many instances the admission of an act of bankruptcy may place directors and officers in a position where they may be personally liable to the debtor and to creditors (New York Stock Corpora-

tion Law, Sec. 15). Yet, the interests of the debtor, its stockholders and creditors may best be served by an immediate approval of a creditors' petition for reorganization with the same force and effect as though it were a voluntary one.

Since the Circuit Court holds that the debtor may not proceed with the creditors' petition as though it had been a voluntary one by the filing of a consent thereto, the only course left open to directors and officers under such circumstances is to put in issue the act of bankruptcy, thereby necessitating a trial of these issues. This would foist upon the court, the debtor and the creditors, protracted and expensive hearings for the purpose of taking testimony of appraisers, engineers and public accountants with respect to the question of insolvency and preference. It would also inevitably delay reorganization and in many cases even defeat an ultimate reorganization. It would doubtlessly adversely affect the debtor's credit position and the operation of its business.

Unless all parties to the controversy immediately consented to a dismissal of the petition, it would be necessary to conduct this protracted and needless litigation in order to clear the ground for a dismissal of the creditors' petition before the debtor could file a voluntary petition for reorganization, which it required in the first instance and sought by its consent. The inherent practical difficulties to such a procedure are apparent.

Furthermore, if the rule laid down by the Circuit Court is to be applied, then even where the officers or directors might be willing to assume the risk of admitting an act of bankruptcy, though issuable or non-existent, such an admission would not be conclusive and would not preclude a creditor or stockholder from insisting upon a trial of that issue. In that event, the same disruption of the functional provisions of the Act would ensue, to the detriment of the debtor and all parties to the reorganization.

Moreover, such a procedure would open up a broad avenue for creditors or stockholders who for personal reasons or gain may desire to delay a debtor in need of reorganization, by contesting an issue which is no longer material.

Surely, such unsatisfactory results, which violate every principle of equitable jurisprudence and which vitiate the functional aspects of the Act, were not intended by Congress and should not be read into the Act.

The instant case furnishes a concrete example of the impractical effect of the Circuit Court's decision. One year after the approval of the petition, the parties are back where they started from, even though all parties agree that the debtor is unable to pay its debts as they mature and can not continue unless reorganized.

POINT III

Rule 15(a) of the Rules of Civil Procedure does not apply to a Chapter X proceeding.

The Circuit Court has held that under Rule 15(a) the debtor could have, as a matter of right, filed a new answer within twenty days after it had filed its original consent.

In construing the provisions of the Act, the Circuit Court treated the consent of the debtor as constituting an "independent petition"; yet in holding that Rule 15(a) was applicable, it treated the consent as being merely an "answer".

It was apparent to the Circuit Court that if it considered the consent as a petition, the debtor might not have been able to withdraw it because of Sec. 59(g). It said: (Tr. 723, 724):

> "On the other hand Sec. 59(g) may give to creditors standing to object to the withdrawal of a petition, though they have not acted in reliance upon it, whenever its pendency gives them an advantage. In Re

> Sullivan, 23 Fed. Supp. 142. Indeed in In Re Epstein, 12 Fed. Supp. 450 (fol. 726), and In Re Browne, 30 Fed. Supp. 157, the court apparently refused leave to withdraw only because the bankrupt had not made out a satisfactory excuse."

The above principles of law apply as forcibly whether the debtor's pleading is termed "a petition", "an answer", or "a consent". Regardless of what nomenclature is applied to that pleading, since it specifically consents to and prays for a reorganization and is the basis upon which the court had assumed jurisdiction and entered its approval order, it should be conclusive and binding on all parties and not subject to withdrawal as a matter of right.

This Court, in *Case* v. *Los Angeles Lumber Co.*, 60 Sup. Ct. 1, 308 U. S. 106, at page 12-13 Sup. Ct., pages 125-127 U. S., said:

> "A debtor as well as a creditor who invokes the aid of the Federal Courts in reorganization or rehabilitation under Section 77B assumes all of the consequences which flow from that jurisdiction.
>
> * * * * * * *
>
> And once the jurisdiction of the court has been invoked, whether by the debtor or by a creditor, that petitioner cannot withdraw and oust the court of jurisdiction. He invokes that jurisdiction risking all of the disadvantages which may flow to him as a consequence, as well as gaining all of the benefits.
>
> * * * * * * *
>
> When that jurisdiction attached, the court rather than the stockholders was in control with all of the powers and duties which that entailed under Sec. 77B."
>
> * * * * * * *

Rule 15(a) can not be applied to circumvent the aforesaid principles of law so as to divest, as a matter of right, the jurisdiction which the court has acquired. It is a Rule

which is limited to amendment of pleadings before judgment. Since an order of approval of a petition is a judgment of a court, that Rule can not be used as a basis for vacating the judgment as a matter of right by merely serving an amended pleading.

POINT IV

The decision of the Circuit Court of Appeals for the Second Circuit conflicts with the decision of this Court and the Court of Appeals of the State of New York.

The Special Master and the District Court have found that the authorization by the board of directors for the filing of the consent to a Chapter X proceeding was "a bona fide and proper exercise by the board of directors of their judgment under the existing circumstances" (Tr. 82). Not the slightest indicia of fraud or bad faith on the part of the directors was established (Tr. 83-84). The Circuit Court has not overruled these findings nor has it in any way disturbed them. The allegations of fraud charged by the majority stockholders were predicated upon the fact that they had desired to proceed under Chapter XI, whereas the directors, in the interest of creditors, and of all stockholders, and the debtor, had consented to a Chapter X proceeding. The Special Master and the District Court held that adequate relief could be obtained only under Chapter X (Tr. 85-86). This finding also has been neither overruled nor even critized by the Circuit Court (Tr. 724).

The Circuit Court said (Tr. 724): "* * * directors, so long as they hold office and use an honest judgment, are immune from the control of their shareholders, *People ex rel. Manice* v. *Powell,* 201 N. Y. 194, 200, 201,". Notwithstanding the recognition of this principle, the Circuit Court went on to say: "the power to commit a corporation one

day before they know they are to be displaced, to a course known to be disapproved by the majority is not one to be generously extended. Normally the shareholders should have their way".

Shall the tenure of office be the test of the propriety of directors' acts? As long as a board of directors is duly constituted and in office, as is the case here, it has the right and duty to act on behalf of the debtor with due consideration to the rights of the creditors and all stockholders.

The directors of a corporation unable to meet its obligations owe a duty to its creditors as well as to its stockholders. Finletter, on page 41, "The Law of Bankruptcy Reorganization" states:

> "The properties of the debtor become charged with a prior responsibility to creditors, as is evidenced by the many restrictions placed upon the directors in dealing with those assets after insolvency supervenes. The directors then cease to represent the stockholders alone and must manage the property for the benefit of creditors as well as stockholders. A provision prohibiting them from filing a petition for bankruptcy reorganization at a time when they might conceive it to be to the best interests of the enterprise as a whole to do so would accordingly seem to be in conflict with the paramount bankruptcy power."

This Court in *Royal Indemnity Co.* v. *American Bond & Mortgage Co.*, 289 U. S. 165, 53 Sup. Ct. 551, held that the directors by resolution may authorize the institution of or the consent to an insolvency proceeding, and that such an act does not require a shareholder's vote for its validity. The Court of Appeals of the State of New York has also enunciated that principle.

> *Rogers* v. *Pell*, 154 N. Y. 518, 527;
> *Young* v. *Stone*, 61 App. Div. 364, 369, 70 N. Y. S. 558 (aff'd 174 N. Y. 517), 66 N. E. 1118.

Indeed even the Circuit Court for the Second Circuit adhered to that principle in earlier cases.

In Re Lone Star Shipbuilding Co., 6 Fed. Rep. (2d) 192, 195;
In Re C. Moench & Sons Co., 130 Fed. Rep. 685, 678;
Regal Cleaners & Dyers Inc. v. *Merlis, et al.*, 274 F. 915, 916.

It is submitted that a board of directors may commit a corporation to a course of procedure in a reorganization proceeding irrespective of the wishes of the majority stockholders, as long as it is a duly constituted board of directors who act in good faith and without fraud. It is immaterial when their term of office is to terminate.

Respectfully submitted,

RAYMOND J. SCULLY and
HILBERT I. TRACHMAN,
Counsel for Petitioners.